



In the Supreme Court of the United States

OCTOBER TERM, 1942.

No.

THE L. A. WELLS CONSTRUCTION COMPANY,
Petitioner and Appellant Below,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent and Appellee Below.

BRIEF FOR PETITIONER.

STATEMENT OF CASE.

Throughout the brief the parties are referred to as they stood in the Court below.

This cause involves the assessment of a deficiency in income and excess profits taxes for the year 1937. The income tax deficiency asserted is Twenty Thousand Nineteen Dollars and Fifty-nine Cents (\$20,019.59) and the excess profits tax deficiency asserted is One Thousand Seven Hundred Three Dollars and Ninety-seven Cents (\$1,703.97). The said deficiency was proposed in the Commissioner's letter (Cleveland I R A : 90 D) dated February 12, 1940.

The hearing in the United States Board of Tax Appeals was had before the Honorable Bolon B. Turner on May 2, 1941 at Cleveland, Ohio, on oral testimony of Howard L. Pittinger, Treasurer of appellant company, and decision for the respondent Commissioner was entered on February 16, 1942, 46 B. T. A. No. 42. It is from this decision of the Board and the affirmation of the Circuit Court that this appeal is directed.

The Circuit Court of Appeals for the Sixth Circuit, on February 11, 1943, affirmed the decision of the Board of Tax Appeals upon the grounds and for the reasons set forth in the opinion of the Board.

QUESTIONS PRESENTED.

1. In accordance with the method of accounting employed by appellant, did the deduction of a loss of Sixty-one Thousand Thirty-one Dollars and Forty Cents (\$61,031.40) sustained by appellant in the year 1937, clearly reflect appellant's income for the year 1937?
2. Did the Board err in sustaining the Commissioner's determination that appellant's contract with the Buffalo (N. Y.) Sewer Authority was a long term construction contract within the meaning of Treasury Regulations pertaining to construction contracts?

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1936 c. 690, 49 Stat. 1666:

Sec. 41. "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year." (26 U. S. C. A. 41.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Article 41-1. "*Computation of net income.* Net income must be computed with respect to a fixed period.

Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

Revenue Act of 1936 c. 690, 49 Stat. 1666:

Sec. 42. "The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *" (26 U. S. C. A. 42.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Article 42-4. "*Long-term contracts.* Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term 'long-term contracts' means building, installation, or *construction contracts covering a period in excess of one year.* * * *" (Emphasis ours.)

ARGUMENT.**POINT I.****APPELLANT'S METHOD OF ACCOUNTING CLEARLY
REFLECTED INCOME FOR THE YEAR 1937.**

The L. A. Wells Construction Company has been, since 1926, engaged principally in marine construction work embracing dredging, building of breakwaters, and the performance of subaqueous construction work of all kinds and has filed its income tax returns in all those years on the calendar year basis. During this period appellant has undertaken some forty-five to fifty projects annually, completing in all five hundred to six hundred contracts. (Rec. p. 12.) Of this entire number seven contracts were commenced in one calendar year and completed in the next calendar year, although so far as indicated the evidence does not disclose, with the exception of the Buffalo Sewer Authority contract, whether these projects contemplated or required a period of more or less than twelve months for completion.

Under the method of accounting employed by appellant, it has been the practice, in connection with projects undertaken, to enter currently on its books the receipts from such projects and the expenditures incurred thereon; the profit or loss on each such project was reflected in appellant's income upon the completion of each undertaking. With the exception of the seven contracts hereinbefore noted profit or loss on each project has been reflected in the year such project was undertaken. Appellant's income tax returns, based on the accrual method of accounting, have been filed annually with the Collector of Internal Revenue for the Eighteenth District of Ohio.

On August 16th, 1937, appellant commenced work under a contract with the Buffalo (N. Y.) Sewer Authority for the construction of an intercepting sewer and sewage treatment plant at Buffalo, N. Y. and the terms of the contract provided for completion of the project in 225 consecu-

tive calendar days from commencement of work unless such period should be extended by the Authority. (Rec. p. 12.) Appellant completed the project on or about July 10, 1938.

During November, 1937, appellant encountered sub-surface difficulties which had not been anticipated and these resulted in labor costs and material costs far greater than had been estimated at the time appellant had prepared its estimates of costs for the entire project. By December 31, 1937, progress payments to appellant totalled \$182,189.62, received or accrued, but expenditures paid or incurred totalled \$244,369.30, or \$62,179.62 in excess of progress payments. On December 31, 1937, appellant debited an account on its books designated "Cost of Jobs—Miscellaneous" with an amount of \$61,031.40, with the following explanation:

"Buffalo Sewer Authority Job in progress
 as of Dec. 31, 1937—Cost..... \$244,369.30
 Estimates allowed on 46.96% of project
 completed to Dec. 21, 1937..... \$182,189.62
 Cost is 134% of estimates allowed.
 Completed contract price is \$382,249.02.
 Continued loss at 134% would cost
 \$512,213.69 to complete causing a loss
 of \$129,964.66.
 46.96% of \$129,964.66 represents known
 loss as of Dec. 31, 1937..... \$61,031.40"

The Board in its opinion (Rec. p. 16) said:

"* * * The testimony of its (appellant's) secretary-treasurer, who had charge of its books, shows that under petitioner's method of accounting for and reporting income from such contracts it was its practice to report the income received and the costs incurred with respect to specific projects in its return for the year of completion. Such a practice contradicts the petitioner's contention that it kept its books and filed its return on the accrual basis."

Citing *H. Stanley Bent*, 19 B. T. A. 181; affirmed, 56 Fed. (2nd) 99.

The Board further said:

"From the evidence it is apparent that the petitioner accounted for and reported its income by the completed contract method."

We respectfully submit that such is *not* the case. (Emphasis ours.) The evidence shows that some five to six hundred contracts were commenced and completed by appellant of which number but seven, including the Buffalo contract, were carried over from one calendar year to the next. The basis of accounting for the very great majority of appellant's contracts was the accrual method insofar as these were reported for income tax purposes. As was said by *Roswell Magill* in 46 *Harvard Law Review* 948:

"Income can be said to have been realized on the accrual basis upon (1) the completion of those operations on the part of the prospective recipient, for which the money or money equivalent is to be paid, plus (2) the happening of a sufficient number of events to make it reasonably probable that a determinable amount of money or its equivalent will in fact be finally paid."

The Board further said (Rec. p. 16):

"With respect to the Buffalo project the petitioner, under the guise of a reserve for loss, seeks to depart from its established practice of accounting for and reporting income and to deduct in its 1937 return an amount (\$61,031.40) representing a proportion of its total estimated loss on the project. Where, as here, the method of accounting employed by the taxpayer clearly reflects income, to permit such departure could not result in the petitioner's net income being computed 'in accordance with the method of accounting regularly employed in keeping the books of such taxpayer,' * * *."

Appellant's "departure" from "the method of accounting regularly employed" in keeping its books was in deducting from its 1937 return "under the guise of a reserve for loss," the sum of \$61,031.40. A proper application of the method employed by appellant would have resulted in clos-

ing into its profit and loss account the sum of \$62,179.62 (1.84% greater than amount actually deducted), the amount by which its expenditures, paid or incurred in 1937 in connection with the Buffalo project, exceeded its receipts, received or accrued in connection with said project. Those figures appeared in the books of appellant as of December 31, 1937. To justify his disallowance of the reserve set up by appellant the Commissioner then, and in this the Board supports his viewpoint, seeks to apply the "completed contract basis" under the Treasury Regulation applicable to "long-term contracts."

POINT II.

APPELLANT'S CONTRACT WITH THE BUFFALO SEWER AUTHORITY WAS NOT A "LONG TERM CONTRACT" WITHIN THE TREASURY REGULATIONS.

Appellant's contract with the Sewer Authority provided by its terms for completion of construction *within 225 consecutive calendar days* from August 16, 1937, unless such period should later be extended by the Authority. (Rec. p. 12.) Work was commenced on the project on August 16, 1937 and was completed on July 10, 1938. The very nature and terms of the contract contemplated a completion of the project within *less than twelve consecutive calendar months*.

The Treasury Regulations provide that a taxpayer may, if he elects to do so, file his income tax returns, *under certain conditions*, on the long-term contract basis. Article 42.4, Treasury Regulations 94, provides as follows:

"Long-term contracts.—Income from long term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term 'long-term contract' means building, installation, or construction contracts covering a period in excess of one year. Person whose income is derived in whole or in part from such contracts

may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. * * *

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. * * *,

Pursuant to these regulations only "long-term contracts" defined as being those "covering a period in excess of one year" could be reported on the alternative "completed contract basis." As is indicated in Volume 1, *Paul and Mertens, Law of Federal Income Taxation*, Paragraph 11.106:

"The regulations issued under the several statutes have provided for alternative bases for reporting income from long-term contracts. These regulations recognize the peculiar situation of building and construction contracts extending over a period of years and are a valid attempt to *allocate income equitably over a period of years.*"

The Board in its findings of fact (Rec. p. 12) states:

"So far as disclosed none of these contracts (seven in number) under which projects were begun in one year and completed in the following year contemplated or required a period in excess of 12 months for completion."

If this be the case and assuming that none of the seven contracts contemplated or required a period in excess of 12 months for completion, appellant, under the regulations, should not have been permitted to use the long-term contract method as an elective in reporting its income for any year, nor under those circumstances should the Commissioner be permitted to depart from the accrual method of accounting and apply a regulation, use of which would not

be permitted the taxpayer. The Board in its opinion states (Rec. p. 17) :

“The regulations under all acts since the Act of 1918 contain the same definition of long-term contract as appears in Article 42-4 of Regulations 94. The rule in the above mentioned cases is grounded not on the length of time covered by the contracts but on the taxpayer’s method of keeping books and reporting income, and, as we said in the *Bent* case, ‘The fact that some of the contracts were performed within a year and some took longer creates no inconsistency in the method and does not detract from a clear reflection of income’.”

But in the *Bent* case, 19 B. T. A. 181, referred to in the Board’s opinion, we note, at page 185, the following:

“Furthermore, since the deficiency has been determined by this method and petitioner *has not established* what in fact was the income resulting from the method he suggests, with the consequent tax liability, the deficiency could not be set aside *on the record* in any event.” (Emphasis ours.)

We submit that in the instant case appellant’s true income for 1937 *has been established* from the facts adduced and the method of accounting employed, and by that method and not by the Commissioner’s determination appellant’s income for 1937 was clearly reflected.

The Board of Tax Appeals in *Robert M. Robinson v. Commissioner*, Docket No. 106,037, entered August 30, 1941 in a memorandum opinion, reported at C. C. H. Dec. 12,056-B, said:

“Even if petitioner had undertaken to use the long-term contract method it would have been the duty of the Commissioner to have refused it under his regulations, because the uncontradicted evidence is that all of petitioner’s contracts covered a period of less than twelve months.”

With this appellant is in accord. In now seeking relief from the Commissioner’s strained and unauthorized use of

the inapplicable "long-term contract" regulation, appellant is not seeking the assistance of this Court in applying a stroke of legerdemain to evade payment of income tax justly due, but rather is asking that this Court apply the principle laid down by the Board in *Owen-Ames-Kimball Company*, 5 B. T. A. 921:

"This petitioner asks that the income from the 13 long-term contracts described in the findings of fact, for each of the years under consideration, be redetermined upon the accrual basis, that is, by treating the income as accruing during the progress of the work under the contracts and allocating the income to the years in which it was actually earned. If the income from long-term contracts is computed in such a manner, all items of income and expense will be consistently accounted for upon the accrual basis, which will clearly and correctly reflect petitioner's net income. But the Commissioner takes exception to this method of accounting for income derived from long-term contracts, on the ground that under most of these contracts the commissions or fees, representing the petitioner's profits, were not due and payable until completion and acceptance of the work and could not be considered as income prior to the time they became due and payable. We think the manner of accounting for income from long-term contracts on the basis contended for by the petitioner is proper under the accrual method of accounting. The accrual method of accounting requires that at the end of every accounting period all income which has been earned during the period must be accounted for as income accrued in that period, though perhaps not collected, because it is not due and will not be collected until some future date. It contemplates that the income shall be determined on the basis of a fair distribution between the periods during which the income accrues. Under such a system of accounting a taxpayer accrues income, it does not receive it. *Appeal of Clarence Shock*, 1 B. T. A. 528 (1925 C. C. H., B. T. A. 2350). Accounting for the income on the basis contended for by the petitioner, the income from long-term contracts is apportioned between the tax-

able years in the same ratio that the work completed in each year bears to the whole, thus accruing the income in the years in which it was actually earned. It conforms entirely with the accrual method of accounting and, as we have said before, the accrual method will clearly reflect the petitioner's net income." (Emphasis ours.)

The method, adopted by the Commissioner and sustained by the Board, results in a distortion of income plainly contrary to the facts. It seeks to impose upon the taxpayer an asserted deficiency in income and excess gross profits taxes amounting to \$21,723.56 arising out of an accounting for the proceeds of a contract which resulted in a net loss to appellant of \$95,343.23. In *Bradstreet Co. of Maine v. Commissioner*, 65 Fed. (2nd) 943, the Court said:

"The burden to adopt a method that will clearly reflect income is on the Commissioner equally as well as on the taxpayer."

Both the Board of Tax Appeals and Circuit Court of Appeals seem to overlook the fact that reporting income from *long-term* contracts on the completed contract basis is not inconsistent with the accrual method of accounting for operations requiring less than twelve calendar months.

The finding by the Board of Tax Appeals is that "so far as disclosed, none of the petitioner's contracts of that type covered a period in excess of twelve months from beginning until completion." It is submitted that in the absence of a showing by the respondent in the record that those preceding contracts were not in fact long-term contracts, the petitioner is entitled to the presumption that they were long-term contracts in that they each required in excess of twelve calendar months.

It is therefore submitted that under the Revenue Act and related regulations it is contrary to law to require that the contract in question be reported on the completed contract basis.

In the text material of *Federal Income Gift And Estate Taxation* by Rabkin & Johnson, 1942 Edition, in paragraph E2 8 under the heading "Long-Term Contracts" we find the following:

"* * * 'The term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Reg. Sec. 19.42-4. But in *Wells Construction Co.*, 46 B. T. A. 302, the taxpayer was held bound to the completed contract method adopted by it with respect to a contract executed in one year and completed in the next, even though the length of the contract was less than one year. Cf. *Robert M. Robinson*, B. T. A. Memo. Dock. 106037, C. C. H. Dec. 12,056-B. The Regulations permit the reporting of long-term contracts under the "percentage of completion" method or the "completed contract" method; but this does not prevent a taxpayer from reporting long-term contract income consistently on the cash basis. G. C. M. 22682, C. B. 1941-1, 307.' "

CONCLUSION.

It is urged that if the decision of the United States Board of Tax Appeals is sustained the appellant will be subjected to an obvious injustice by a strained and unauthorized application on the part of the Commissioner of Internal Revenue of an inapplicable Treasury Regulation.

The appellant was justified in accounting for its income for the year 1937 in the manner adopted by it. Its recording of the transaction with the Buffalo Sewer Authority reflected more accurately its true income for that year than did the measures taken by the Commissioner. Surely it cannot be determined that income was realized from a venture that resulted in an indisputable loss in excess of Ninety-five Thousand Dollars when such determination seeks its justification by the application of a yard-stick, use of which properly would be denied taxpayer.

This Honorable Court, therefore, is requested to recognize the obvious injustice of the decision of the United States Board of Tax Appeals and exonerate this appellant from the burden of the deficiency asserted to the extent indicated.

Respectfully submitted,

MAYER A. COOK,

Solicitor for Petitioner.